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DOW THEORY LETTERS INC.

"The Market as Interpreted under the Dow Theory"

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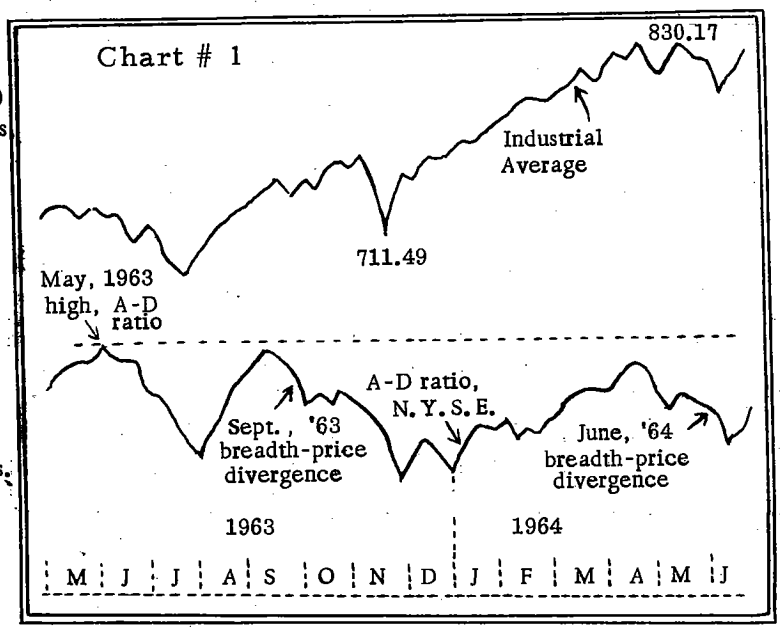
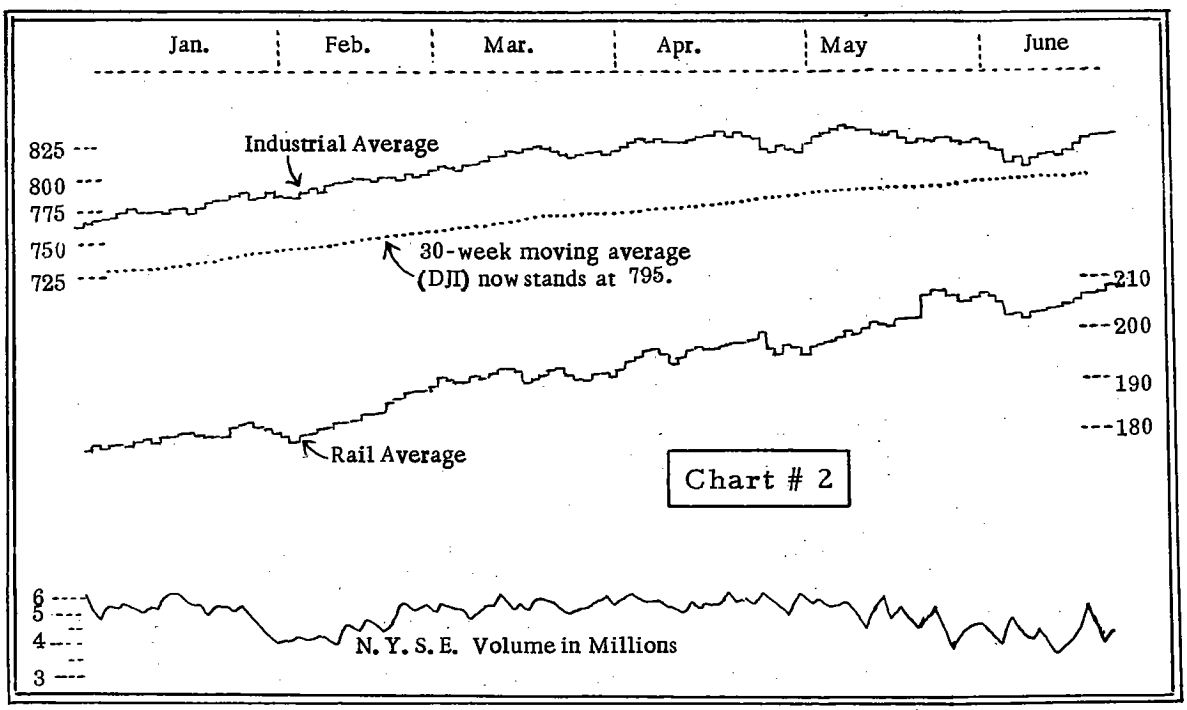
THE MARKET: Last week more phone calls and telegrams converged on this office than during any week since 1962. It was obvious that confusion was king. The reason for the excitement (see Chart 3) was obvious enough. Since March, the market has reversed its direction on six consecutive occasions. One caller remarked that it all reminded him of the story about the broker who was harried simultaneously by a frantic market and a frantic client. "This crazy market," moaned the client, "Where's it going?" "Going," cried the broker, "I don't even know where it's been!"

Perhaps the worst sufferers over the past few months have been those investment services which feature special "buy" and "sell" telegraphic services. The telegrams have been going out so thick and fast that undoubtedly the prime beneficiary of the whole operation has been the Western Union Co. There is only one procedure that the writer follows when a market becomes as tricky and difficult as this one. I leave it alone. It may be that the market is now being studied (I should say scrutinized) by too many analysts, traders and investors. When this occurs the market (which never obliges any large group) invariably becomes inscrutable. It could well be that we are witnessing a case of too many market cooks spoiling the broth.



Profits for the bulls have been scattered and sporadic. Essentially, the bulls are waiting for a move "to 900" on the Dow. Such a move, it is felt, will put most of their holdings in the profit side of the ledger. The bears are of the opinion that "the market" (actually the mass of stocks) has done little on balance for over a year. Furthermore, they note that the Industrial Average has made no progress for over three months. They believe a major "top" is being formed and that time is working against the bulls.

Question: Is the primary trend still up? Answer: Under Dow Theory, the prevailing trend is taken to remain in force until proved otherwise. The last trend was bullish. In the Letter of June 11, I wrote: "It should be remembered that it is what occurs after the first (upward) correction of the initial decline which will determine the seriousness of the situation. The last confirmed highs in the Averages occurred on May 7. The time is approaching when a correction of the downward movement should begin. Following the correction, if the two Averages rally to new highs (above 830.17 and 207.31) the continuation of the main bull

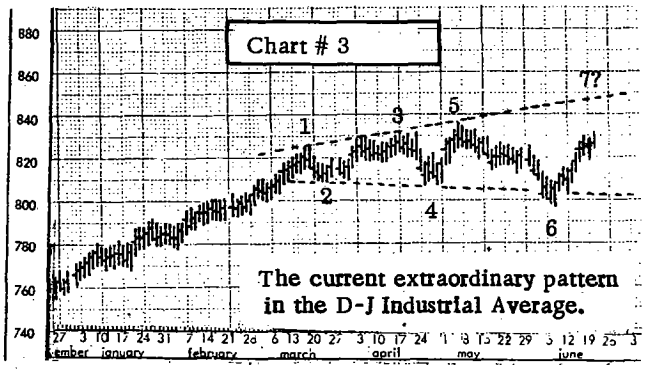


movement will have been signalled. Conversely, if the two Averages (following a corrective rally) then turn down and break whatever lows are now being established, then Dow's Theory will have signalled the existance of a bear market."

The lows for this decline were recorded for Industrials and Rails on June 8 at 800.31 and 201.83 respectively. Although these lows are perhaps too shallow to be considered as full reaction bottoms, they certainly represent important points. As long as one or both averages hold above these lows the bull trend will be considered intact. And although there is room for argument, I would be inclined to think that a high-volume penetration of the 800.31 and 201.83 levels would represent a primary reversal.

Question: What is the meaning of the recent concentrated series of technical "danger signals", the breadth-price divergence in September, 1963, the breadth-price divergence in June, 1964, the recent "broadening formation," the "false breakouts" in many individual stocks? Why hasn't the market as a whole been shattered by all this technical deterioration? Answer: When a man (or a bull market) is very old, the actual momentum of his years seems to carry him along. He may develop cancer (which will kill a young man quickly), he may have lung trouble, poor eyes, an ulcer, pains in his legs. But incredibly he goes on living (often making a fool out of the young doctor who five years ago gave him six months to live). But what are five years in an old man's life? And what veteran physician is so presumptious as to predict exactly when the patient will breathe his last?

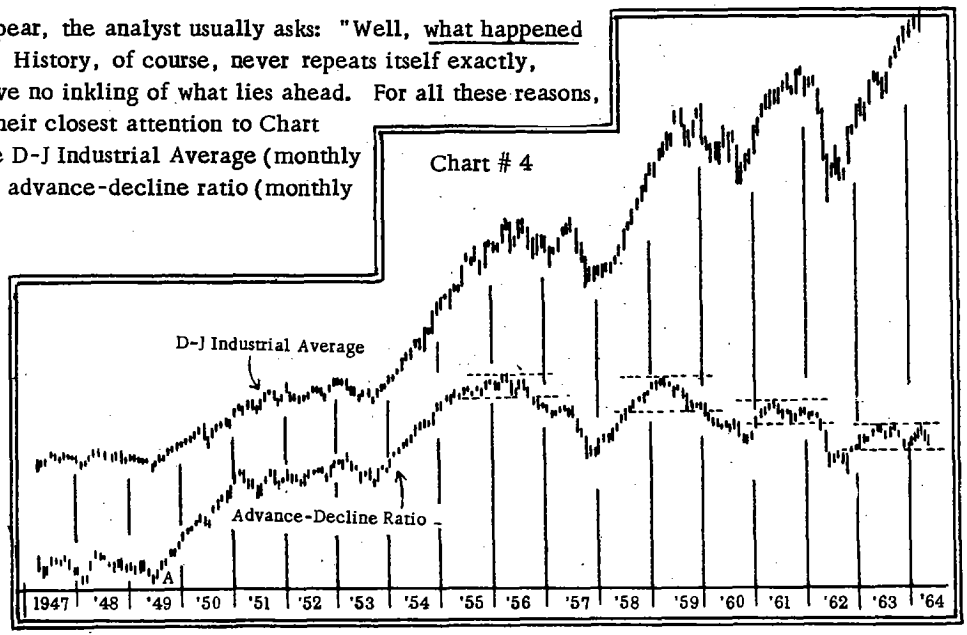
Question: In the last Letter you drew attention to a "broadening pattern" in the Industrial Average which was formed and completed during the March-June, 1964, period. What would you say if Industrials rose to a new high (above 830.17) and then pushed to the upper trendline of the broadening formation again? Answer (see Chart 3): If, after the reversal at point 6, the rally carries Industrials to a new high or to the vicinity of point 7 on the chart, I would say that this fantastic market has produced the only six-point reversal pattern that I have ever seen. In case of a new Industrial high, all eyes will be on the upper trendline at theoretical point 7. My own guess would be that point 7 (at about the 840-845 area) would represent a level from which a dangerous reversal might be expected. There is no question about one thing — if Industrials now rise above the old high (above 830.17) we will have a new pattern for the textbooks.



THE PROBLEM: Many investment services deal in "secret formulas", enigmatic "investment indexes" and generally unexplained statements and conclusions. Personally, I do not like secrets, and I have always insisted that subscribers understand the thinking behind my own bullishness or bearishness. If readers do not fully comprehend why my conclusions are weighted one way or the other — then these Letters lose a large part of their value.

Since June, 1962, the two Averages have traced a series of successive new highs. Yet unlike the periods of 1953-56 or 1957-59, most people have found it extremely difficult during the 1962-64 period to make money in the market. What is wrong? The answer lies in the trend of the majority of stocks (breadth). Since October, 1962, despite the steady rise in the Averages, we have seen only seven months in which breadth has made consistent upside progress. These were the months from October, 1962, to May, 1963. Since May, 1963, the A-D ratio has failed to show any advance; it is this situation which has rendered market operations so difficult and generally unprofitable.

When technical problems such as this one appear, the analyst usually asks: "Well, what happened in the past when this same situation arose?" History, of course, never repeats itself exactly, but without knowledge of the past we can have no inkling of what lies ahead. For all these reasons, I feel it is important for subscribers to give their closest attention to Chart # 4. This Chart traces the movements of the D-J Industrial Average (monthly high and low ranges are shown) and the daily advance-decline ratio (monthly high and low ranges) from 1947 to present.



The chart shows that over the past decade breadth and price have progressed in a definite sequence. The sequence is as follows: (1) the A-D ratio and the Industrial Average embark on a broad and profitable advance together, (2) the A-D ratio forms a "trading range" while the Industrial Average goes on to record successive new highs, (3) a general "stalemate" occurs, following which the A-D ratio breaks down below the trading range, (4) the Industrial Average finally confirms the general market weakness by going

into a major decline along with the A-D ratio, (5) breadth and price get "in gear" on the downside, thus paving the way for the next major rise.

The massive 1953-56 advance (see chart 4) took the A-D ratio to an historic high in March, 1956. As seen on the chart, the 1956 action resulted in a prolonged trading range for the A-D ratio. In March, 1956, a breadth-price divergence occurred, and a second divergence developed a few months later — in July, 1956. In September of that year the A-D ratio broke below its entire trading range. The slide in the A-D ratio continued to a final low in December, 1957. In July, 1957, the Industrial Average joined the decline, and during the next three months the senior Average made up for lost time by dropping 100 points.

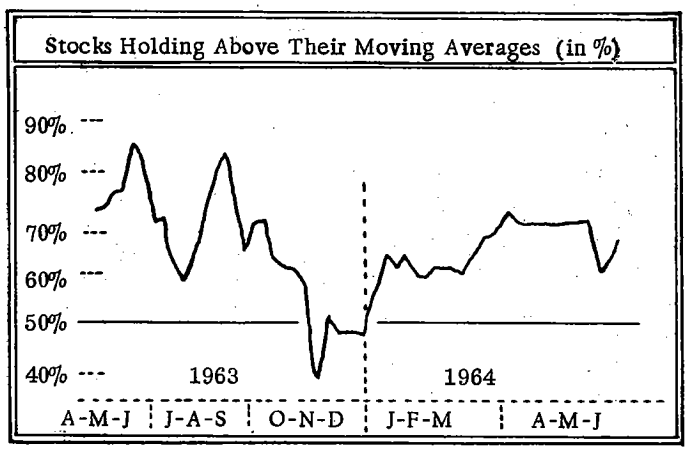
A new advance began in December, 1957. The 1957-59 advance continued for the majority of issues until March, 1959. As seen on the chart, breadth then worked sideways into a tedious trading range despite a series of new Industrial highs. Breadth-price divergences were completed in May, 1959, and January, 1960. When breadth finally broke its long trading range in January, 1960, the Industrials confirmed by dropping 85 points in a matter of two months. The decline continued until October, 1960.

A new advance began in late 1960. The 1960-61 rise carried breadth to a peak in May, 1961. Another extended and frustrating trading range was traced out by the A-D ratio during the succeeding eleven months. The trading range held until the second quarter of 1962. In April the A-D ratio plunged below the 1961-62 trading range. This action was immediately confirmed by the Industrial Average which broke its own ten-month range in April. During May and June the entire market suffered the worst spring collapse in Big Board history.

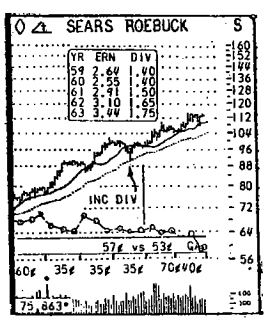
From a final low (in breadth) recorded in October, 1962, the market pushed up in a broad advance. The A-D ratio struck a peak in late-May, 1963, seven months after the advance began. From the May, 1963, high, the breadth index has flattened out again in what must be considered another long trading range. The (current) 1963-64 range for the A-D ratio is bordered by the May, 1963, high and the November, 1963 (Kennedy panic) low. Breadth-price divergences occurred twice during this trading range — in September, 1963, and in April-June, 1964. These divergences occurred on the two occasions when the A-D ratio neared the May, 1963, peak. All of which brings us to the present.

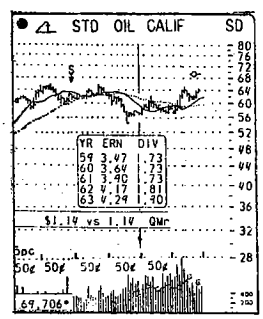
What can we expect in the period ahead? Based on the breadth-price action of the past decade, we can expect the current trading range in the A-D ratio ultimately to be broken on the downside (in other words, a break below the November low). This should be accompanied by a major decline in the Industrial Average, a decline whose proportions cannot be predicted in advance (although Industrials would have to break below their own 711 low of November, 1963, in order to get in gear with the A-D ratio on the downside). It is well to remember that once breadth forms a trading range (as is certainly now the case), we have not had another important advance in the A-D ratio until (after) a major decline has taken the A-D ratio below its trading range — and until Industrials have confirmed that decline.

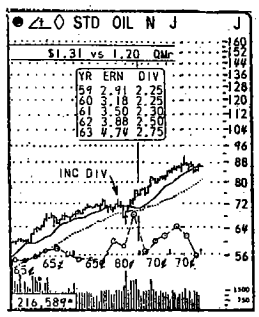
STOCKS: Of 432 representative Big Board stocks which are tabulated here weekly, 285 or 66% are now holding above their long-term (200-day) moving averages. This is a rise of 4% from last week, but it is worth noting that the bullish percentage was 70% last time the Industrial Average was in the 820-830 area. In other words, fewer stocks are participating in this rally than was previously the case (see accompanying chart).

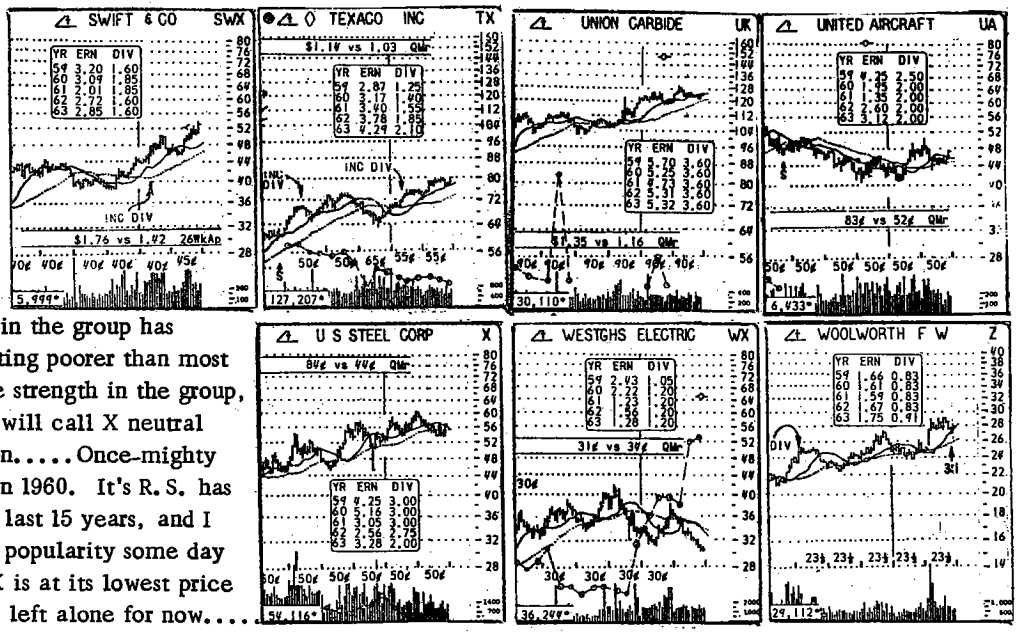


The following paragraphs complete the discussion of the thirty D-J Industrial components: S (see small weekly charts) is now at an all-time high. The stock has been out-performing the market for over five years, and its relative strength line (R. S.) is consequently at a new high. As seen on the chart, S is holding above both its 10-week moving average (M. A.) and its longer-term 200-day M. A. (dotted line on chart); the stock is clearly bullish..... SD recorded an all-time high of 69 in early 1963. Since then its R. S. line has been steadily dropping. The fact that SD is now above both its M. A. lines suggests that it may try for the 1963 high again. I rate SD neutral-bullish..... J is a few points below its (1964) all-time high and clearly bullish... ... TX is at its all-time high and also bullish; the three oils are obviously among the strongest stocks in the Industrial Average..... UK struck its all-time high of 150 in 1959. Since the 1962 low UK has just about kept up with the market, a performance which resulted in its R. S. line moving sideways for over two years. UK can be considered neutral-bullish as long as it holds above 118... ..UR hit its bull market high of 80 in 1959. The stock









has been trading in a range bordered by 41 and 50 for a year. A rise to 51 or a break to 40 will tell the story from here. Meanwhile the stock might be labeled neutral.....X hit its high of 108 in 1959. After declining since 1959, the R. S. of the entire Steel Group turned up recently, and this could bode well for X. The competitive position of X in the group has deteriorated and the stock has been acting poorer than most of the other steels. Were it not for the strength in the group, I would label X neutral-bearish, but I will call X neutral with generally uninspired market action.....Once-mighty WX touched a bull market high of 65 in 1960. It's R. S. has now dropped to the lowest level of the last 15 years, and I wonder if this stock may not regain its popularity some day (a la Chrysler). In the meantime, WX is at its lowest price level since the '62 crash and should be left alone for now.... Z recorded a bull high of 93 in 1961. It has touched 88 three times since April but still has not bettered the level. R.S. has declined in the past few weeks, and the critical test is at hand. The stock has just been split 3 for 1 which means that Z should hit 30 (on the new stock) to be in line for an assault on the 1961 high. The 200-day M. A. for Z is at 26, and as long as it holds above that figure it should be labeled bullish.

Two interesting issues are Burroughs and MGM. BGH is now at approximately a ten-year low. The stock (once labeled a "growth issue") pays a $1.00 dividend which affords a fair yield. BGH has held at the 22 level on five consecutive occasions since November; it has recently formed a rectangle after moving sideways through a long descending trendline. Its relative strength line also appears to be about to reverse to the upside. Risk in BGH — 3 points; it can be bought here and sold if it breaks 22.

The huge rectangle (B) in MGM has taken the stock through its bearish descending trendline (A). Relative strength on MGM has turned up after a three year decline. As seen on small insert chart, MGM is holding above both moving averages. It could be bought here and sold if it penetrates its 10-week moving average (solid line) which is now 34. Breakout point on MGM — 38.

Small weekly charts of Dow stocks and BGH courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas.
Larger weekly charts of BGH and MGM courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois 62003.